Annexes to the 2004-2006 stability programme

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I. Macroeconomic assumptions to 2006

I.1. Current situation and short-term outlook

The U.S. economic slowdown and its impact on international trade weighed on exports and activity in France in 2001. In response to weakening foreign demand for French goods and services, companies have reduced capital expenditure budgets and adjusted their inventories. The economic turnaround that began in 2002 in the U.S. and Europe lost some momentum in the summer in a context of increasing international uncertainty and volatile financial markets. Business demand is expected to improve later in the cycle and capital spending will remain flat in 2002. While healthy household demand limited the slowdown in 2001, household savings trends have become more cautious in recent quarters. Consumer spending will rise by only 1.8% in 2002 (following 2.6% in 2001). Total growth should be approximately 1.2% in 2002, and, after two years of weak growth, the French economy will remain penalized by the particularly slow pick-up in demand in 2002[1].

In 2003, growth should increase to 2.5%, on average, for the year. Bolstered by strengthening worldwide demand, exports will improve. Household spending, benefiting from the progressive decline in inflation and tax cuts, will advance 2.4% in 2003. Business investment will rise by 3% in 2003 in response to an improved outlook for demand and declining interest rates.

After an exceptional rise in 2000, market sector employment growth registered a sharp slowdown in 2001, precipitating a marginal upturn in unemployment, which in October 2002 stood at 9%. Despite the economic turnaround in 2002 and the positive impact of different measures to reduce the cost of labour (further reductions in social security contributions in favour of low-skilled employment, the progressive reform of the local business tax, and social charge exemptions on employment contracts in favour of young workers), efforts by companies to re-establish margins will limit unemployment growth in 2003. Job creation should consequently continue to advance at a modest pace over the following quarters. After registering an average annual increase of 2.8% in 2001, market sector employment will grow 0.7% in 2002 and 1.1% in 2003.

I.2. Outlook up to 2006

Growth potential currently near 2.5%

The French economy's growth potential is widely seen to have increased from approximately 2¼% p.a. in the mid-90s to nearly 2½% in recent years following a reduction in structural unemployment and strong capital spending. Growth of total factor productivity (productivity of labour and capital combined) will be approximately 1.1% p.a., with a figure in the region of 0.5% for the working population in 2002 and 2003.

Two scenarios for actual growth are proposed: the first is intentionally conservative at 2.5% p.a., while the second – 3.0% p.a. – is more ambitious. These scenarios correspond to an estimated annual potential growth ranging between 2¼% and 2¾%.

- The 2.5% growth scenario is consistent with the lower range for potential growth (2¼%), and is based on stable employment rates and projections for the working population produced by INSEE. Business investment will increase by 5% p.a. starting in 2004, after 3% in 2003. This modest growth will enable capacity utilization rates to return to the historical average between now and the end of the period.

[1] According to the first estimates for the third-quarter national accounts, cumulative growth for 2002 will be 0.9% at the end of this quarter. The first estimates for fourth-quarter accounts will be published on 21 February 2003.

- The 3% growth scenario is consistent with the upper range for potential growth (2¾%). This higher projection supposes a growth in the employment rate and a more dynamic labour supply combined with stronger capital accumulation.

In both these cases, the trend for total factor productivity underway since the 1990s will persist, and the French economy will partially absorb its initial output gap (1¼ GDP points in 2002) over the forecast period.

Starting in 2003: healthy, sustained growth in a context of low inflation

Activity will advance at a healthy, sustained pace from 2003 onward. Inflation will stabilize at around 1.5% p.a. over 2004-2006, as demand progressively catches up with potential supply. The strong growth in both scenarios will be driven by final domestic demand, as the contribution from net exports and inventories will be nil. In both scenarios, household spending will keep pace with purchasing power, which will advance at the same pace as activity (2.5% or 3% p.a.). Capital spending trends will also be more dynamic in the 3% growth scenario.

Medium-term interest rate assumptions

These medium-term growth scenarios suppose that the French and other euro area economies will progressively absorb the output gap that they have accumulated over the last two years. At the same time, after temporarily increasing in 2001 and 2002 in response to rising energy and food costs, inflation should return to levels consistent with European Central Bank targets in 2003. As a result, in these two scenarios euro area inflation will remain close to 1.8% from 2003 to 2006.

In the projections, three-month interest rates in the euro area will be constant in real terms starting in 2004. In addition, the spread between long and short-term rates is expected to remain stable. On average over the last 20 years, this spread was 80/90 bp in Germany and 100/110 bp in France. In our projections, spreads between short and long-term rates will be slightly more than 100 bp over the medium term.

2004-2006 average	**2.5% scenario**	**3% scenario**
GDP	2.5%	3.0%
Domestic demand	2.6%	3.1%
Household spending	2.6%	3.1%
General government consumption	1.1%	1.1%
Gross fixed capital formation	3.5%	4.7%
Of which businesses[2]	5.2%	7.2%
Contribution of inventories	0.0%	0.0%
Exports of goods and services	5.5%	6.1%
Imports of goods and services	5.5%	6.1%
GDP prices	1.5%	1.5%
Consumer prices	1.5%	1.5%
Private sector payroll	4.2%	4.7%
Nominal average private-sector wage per capita	3.1%	3.1%
Private sector wage earners	1.1%	1.6%

[2] Non-financial corporate enterprises and unincorporated enterprises

I.3. Sensitivity tests regarding the macroeconomic scenarios

The macroeconomic scenarios retained in the multi-year programme are based on a series of assumptions concerning the French economy's international, social, and financial environment, which are naturally subject to a certain number of risk factors. International forecasts for 2003 are based on the following assumptions, which, for the most part, have been extended over the 2004-2006 period:

- A progressive return of world trade to its long-term growth trajectory. The U.S. will grow by 2.3% in 2002 and 2.7% in 2003, vs. 2.3% in these two years according to European Commission forecasts[3]. The Japanese economy will decline by 0.7% in 2002 and grow by 1.4% in 2003, vs. -0.6% and +1.2%, respectively. Growth forecasts for the euro area are identical in 2002 (0.8%) and slightly lower for the Commission in 2003 (1.8% vs. 2.1%). Overall, these differences are consistent with projections for worldwide demand for French goods (2.2% in 2002 and 6.8% in 2003), estimates that are slightly higher than those of the Commission.
- Stable oil prices at US$ 25 per barrel, compared to US$ 24.1 in 2003 and US$ 22.5 in 2004, according to the Commission.
- Stabilization of the euro exchange rate at US$ 0.98 starting in September 2002, in line with the assumptions retained by the Commission.

It is possible to assess the impact of a change of assumptions to the French economy in light of a slowdown in world demand for French goods and services, a decline in oil prices, and interest rate reductions.

A. Impact of weaker world demand for French goods and services

A slowdown in world demand for French goods and services begins by affecting export sales almost exclusively, and then filters through the rest of the economy, particularly in the form of lower levels of corporate investment.

At constant nominal interest rates, a permanent 1% downturn in world demand would shave economic activity by about one-quarter point of GDP, leading to a loss of approximately 30,000 jobs after two to three years. The impact on inflation would be almost nil (at fixed exchange rates).

By way of example, a 1% contraction in world demand for French goods and services could be caused by a temporary slowdown in U.S. growth of 0.67 point and a spill-over effect on the entire world economy.

Impact on the French economy of a 1% drop in world demand for French goods and services (1)

(Deviation from the benchmark scenario as a %)

	2004	2005	2006
GDP	-0.2/-0.3	-0.3	-0.2/-0.3
Total employment (in thousands)	-5/-10	-25	-30
Household consumption prices	0.0	0.0	0.0
Government net lending (in GDP points)	0.0	-0.1	-0.1

(1) This durable decrease in world demand by 1% is supposed to take place at the beginning of 2004.

[3] In the 'Economic Forecast: Autumn 2002' report

B. Impact of a decline in oil prices

A durable decline in oil prices would provide a positive supply shock to the French economy and its principal industrial partners. A fall in oil prices would result in a drop in imported inflation and would have a direct curbing effect on consumer prices. In addition to this automatic mechanism, prices would be pulled down by the slowdown in business production costs and wage indexation on prices. The combined impact of declining consumer prices and improved company earnings would boost activity.

Under traditional macroeconomic models, a durable 20% decline in oil prices in U.S. dollars (from US $25 to US $20), provided European macroeconomic policies remain unchanged, would lead to additional growth of approximately two-tenths of a percentage point and a decline in consumer prices by slightly more than one-half of a percentage point at the end of two years.

This disinflation would also permit further easing of monetary policy in the euro area, providing additional stimulus to demand.

Impact of a 20% decline in oil prices on the French economy in U.S. dollars (1)

(Deviation from benchmark scenario as a %)

	2004	2005	2006
GDP	0.1	0.2	0.2
Household consumption prices	-0.3/-0.4	-0.5/-0.6	-0.5/-0.6
Government net lending	0.0	0.0	0.1

(1) This decline in the price of a barrel of Brent oil from US $25 to US $20 is supposed to take place in early 2004 (interest rates are unchanged).

C. Impact of a 100 bp decrease in interest rates in the euro area on the French economy

Downward pressures on the international environment and the outlook for activity in the euro area could contribute to further drops in European interest rates.

A decrease in both short- and long-term rates would consolidate activity in three ways: cost of capital, a shift from savings to consumption, and exchange rates:

- Business investment would benefit most from lower rates as lower financial charges improve corporate solvency and raise return on capital employed;
- Housing investment would benefit from cheaper loans and lower interest rates would encourage household consumption in relation to savings (substitution effect);
- Depreciation of the euro due to lower interest rates would boost economic activity by making France more competitive vis-à-vis countries outside the euro area.

At a fixed exchange rate, a 100 bp decrease in short- and long-term rates in the euro area would boost economic activity by nearly one-quarter of a GDP point in the first year and by three-quarters to one point in the second and third years. The impact on inflation would be marginal as domestic prices would only react slightly to this rise in activity.

These assumptions factor in the effects of the macroeconomic dynamics within the euro area, i.e. the positive impact on the French economy of stronger demand among its euro area partners.

Impact of a 100 bp decrease in interest rates in the euro area (1)

(Deviation from benchmark scenario as a %)

	2004	2005	2006
Without an appreciation of the euro			
GDP	0.2	0.7/1.0	0.7/1.0
Total employment (in thousands)	7.5	60/75	60/75
Household consumption prices	0.0	0.1	0.2
Government net lending (in GDP points)	0.1	0.2	0.3/0.5

(1) This durable decrease of 100 in short- and long-term interest rates is supposed to take place at the beginning 2004 on the basis of fixed exchange rates.

Lower interest rates affect public finance in two ways: first, the debt service burden of the general government decreases because the cost of refinancing existing debt and financing new deficits goes down; and second, the boost given to economic activity leads to an improvement in the public accounts.

Given today's debt maturity, a 100 bp interest-rate decrease would result in a significant reduction in interest expense for the general government by 2006.

Public revenue and expenditure would both be affected by stronger activity:

- Stronger growth automatically generates higher tax and social security revenue. However, gains in social security revenue, which are mainly based on the payroll, are not very sensitive to the nature of the extra demand. This is in sharp contrast with central government revenue, which is much more dependent of the composition of additional demand. For instance, VAT revenue is boosted by increased household demand but is scarcely affected by rising export sales.
- Nominal expenditure (excluding interest expense) would be reduced by improvement of the labour market and aggravated by the fact that most expenses are pegged to inflation (payroll, benefits, etc.).

II. General government balance

The audit of public finance conducted in June 2002 indicated a significant deterioration in the public accounts. Whereas the 2003 Budget Bill forecast a public deficit of 2.6 GDP points, the 2002 Supplementary Budget Bill currently foresees a general government deficit of 2.8 GDP points. This worsening of the deficit reflects unfavourable trends for unemployment insurance expenditure aggravated by further shortfalls in receipts.

In 2003, the public deficit should improve by 0.2 points to 2.6 GDP points. This improvement reflects the net impact of the reduced weight of expenditure in GDP and a slightly lower reduction in the weight of revenue in GDP (0.5 GDP points). In effect, the Budget Bill provides for stricter control of public spending. Growth in real expenditure would be 1.2% next year on average, after 3.6% in 2002[4] and 2.2% over 1998-2002. Central government real expenditure will rise by 0.2% (compared to the level reached in the supplementary budget of summer 2002, incorporating recurring public expenditure items). In terms of social security expenditure, the budgeted increase for national health insurance spending target[5] is 3.7% in real terms in 2003.

The declining share of public revenues in GDP in 2003 is a consequence of three factors:

- Tax and social security contribution cuts;
- The automatic decline of tax revenue (low 2002 growth weighing on revenue projections for 2003) linked to the income and corporate tax collection system;
- Non-tax revenue, which will decline after contributing exceptionally high amounts in 2002.

[4] The figure published in the Economic, Social and Financial Report included in the 2003 Budget Bill was 3.2% at constant prices. Since this assessment, estimates for unemployment benefits and certain central government expenditures have been revised upwards.
[5] ONDAM (*Objectif national des dépenses d'assurance maladie*)

Over 2004-2006, notable reductions in the public deficit will be achieved through improved control of public spending. Growth in health insurance benefits will keep pace with GDP at 2.5% p.a. at constant prices. The weight of public expenditure in GDP will decline by 1.9 points over 2004-2006, while the public deficit will be reduced to 1 GDP point in 2006 under the scenario of actual growth of 2.5%. In this same year, in the more favourable scenario of 3% growth, a close-to-balance position would be achieved, with general government net borrowing representing 0.5 GDP points.

Table 1: Key indicators of public finance (2.5% growth scenario)

In GDP points		2.5% growth		
	2003	**2004**	**2005**	**2006**
General government net lending (+) / net borrowing (-)	**-2.6**	**-2.1**	**-1.6**	**-1.0**
Expenditure	53.4	52.8	52.2	51.5
Revenue	50.8	50.7	50.6	50.5
Current tax burden (including EU levies)	44.3	44.3	44.2	44.1

Table 2: Key indicators of public finance (3% growth scenario)

In GDP points		3% growth		
	2003	**2004**	**2005**	**2006**
General government net lending (+) / net borrowing (-)	**-2.6**	**-2.0**	**-1.3**	**-0.5**
Expenditure	53.4	52.6	51.7	50.8
Revenue	50.8	50.6	50.4	50.3
Current tax burden (including EU levies)	44.3	44.2	44.0	43.8

Balances by sub-sectors

The decrease in general government net borrowing reflects first and foremost a reduction in central government net borrowing by 1.1 GDP point between 2003 and 2006. This achievement is due, above all, to improved control of central government spending, expected to grow by only 1% at constant prices on a like-for-like basis over 2004-2006 (in budget accounting). At the same time, central government will bear the principal weight of the reduction in the tax burden, by compensating shortfalls in social security funds from additional reductions.

In both scenarios, net lending of other central government bodies and local government will improve marginally by 2006. Budget balances of other central government bodies will improve with the progressive amortisation of social security debt owed by the social security debt repayment fund[6], defeasance debt reduction, and the accumulation of assets in favour of the pension reserve fund[7].

Local government accounts will profit from ongoing debt reduction, the stabilization in the long-term care allowance for the elderly[8], and the end of the impact of the reduction in the working week. This forecast provides only an indication of current trends and does not take into account, at this stage, the impact of the reorganization of authorities within the framework of the new decentralization reform.

Net lending of social security funds will stabilize at a balanced level in the 2.5% scenario, whereas in the 3% scenario they will post a surplus of 0.4 GDP point in 2006.

[6] CADES (*Caisse d'Amortissement de la Dette Sociale*)
[7] FRR (*Fonds de Réserve pour les retraites*)
[8] APA (*allocation personnalisée d'autonomie*)

Table 3: Net lending/borrowing of general government

In GDP points				2.5% growth		
	2001	**2002**	**2003**	**2004**	**2005**	**2006**
General government	**-1.4**	**-2.8**	**-2.6**	**-2.1**	**-1.6**	**-1.0**
Central government:	-1.9	-2.8	-2.5	-2.3	-1.9	-1.2
- State	*-2.3*	*-3.4*	*-3.0*	*-2.8*	*-2.5*	*-1.9*
- Central government bodies	*0.4*	*0.6*	*0.5*	*0.5*	*0.6*	*0.7*
Local government	0.2	0.2	0.1	0.2	0.3	0.3
Social security funds	0.3	-0.2	-0.2	0.0	0.0	0.0

Net lending/borrowing of general government

In GDP points				3% growth		
	2001	**2002**	**2003**	**2004**	**2005**	**2006**
General government	**-1.4**	**-2.8**	**-2.6**	**-2.0**	**-1.3**	**-0.5**
Central government bodies	-1.9	-2.8	-2.5	-2.3	-1.9	-1.2
- State	*-2.3*	*-3.4*	*-3.0*	*-2.8*	*-2.5*	*-1.9*
- Central government bodies	*0.4*	*0.6*	*0.5*	*0.5*	*0.6*	*0.7*
Local government	0.2	0.2	0.1	0.3	0.3	0.4
Social security funds	0.3	-0.2	-0.2	0.1	0.2	0.4

Structural balance of general government

The structural balance declined approximately by 1 GDP point between 1999 and 2002 to reach 2.1% of GDP in 2002, against 1% in 1999.

Over 2004-2006, the structural balance should improve by 1.25 points based on the lower projection (2.25% p.a.) to more than 1.75 GDP points for the upper projection (2.75%) for growth potential. Based on a consensual estimate for growth potential consistent with the European Commission (approximately 2.5% p.a.), the structural balance would improve by 0.5 GDP points p.a. over the 2004-2006 period[9] for actual growth of 2.5% p.a.

III. General government expenditure

The strategy for managing public finances is based on the control of public spending. This requires the establishment of targets for increases in real terms for all expenditures of the general government subsectors.

Average growth at constant prices for public expenditure of 1.3% p.a.

While public spending increased 2.2% p.a., on average, over 1998-2002, the 2004-2006 stability programme provides for a reduction to 1.3% p.a. at constant prices. This target reflects significant public spending control efforts, given the increased weight of debt service charges and the ageing of the population in the coming years.

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[9] French growth potential is estimated at between 2 ¼% and 2½% p.a., on average, in real terms over 2004-2006 by the OECD and the IMF, and slightly more than 2½% by the European Commission.

Table 4: Cumulative growth in real expenditure – 2004-2006

(2.5% growth scenario)

At constant prices	2004-2006 programme
General government	**3.9%**
Central government (budget accounting)	1.0%
Central government (national accounts)[1]	2.4%
Social security funds	5.0%
Of which:	
- Healthcare	*7.7%*
- Retirement pensions	*7.1%*
- Other [10]	*-0.6%*
Local government	5.8%

[1] See the box in the "central government expenditure" section: changeover from general budget expenditure to national accounts expenditure.

In the 2.5% growth scenario, public expenditure as a percentage of GDP will drop by 1.9 GDP points between 2003 and 2006. In the 3% scenario, public expenditure in GDP will decline by 2.6 GDP points between 2003 and 2006.

The progressive increase in retirement expenses during the programme period as the baby boom generation reaches retirement age in large numbers will be offset by the impact of a slowdown in rising budgetary expenditure of the central government and central government bodies over 2005-2006. Local government expenditure will also increase marginally in relation to the preceding stability programme driven by local investment cycles.

Table 5: Public expenditure growth

% p.a.	2003	2004	2005	2006
Real public expenditure (all government subsectors combined)	1.2	1.4	1.3	1.2

The non-linear evolution of public spending particularly reflects the handling, with respect to the national accounts, of France's contribution to the European Community budget (box on page 11).

Central government expenditure

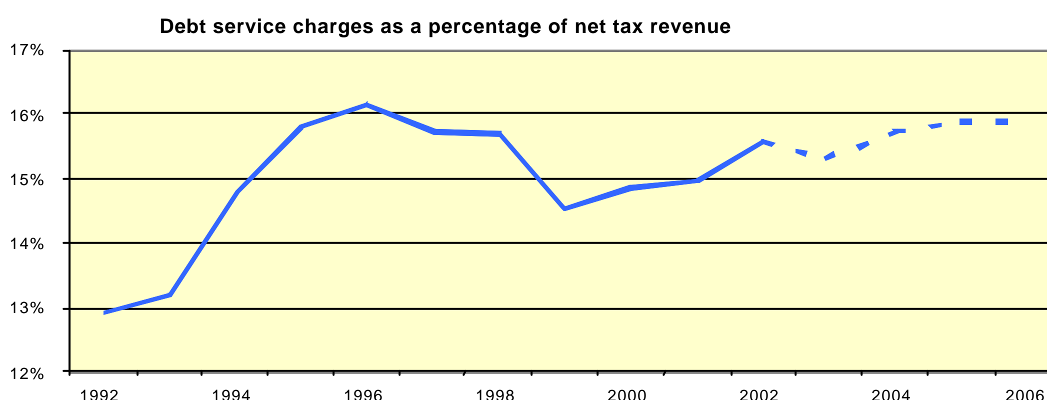
General budget expenditure will increase by 0.3% p.a. at constant prices over 2004-2006, in an environment characterized by increasing debt service charges and retirement liabilities.

Debt service charges

Debt service charges (14% of net expenses of the general budget in 2003) should increase faster than total central government expenditure over the 2004-2006 period at constant interest rates: +3.7% p.a. on average in real terms (+ 1.2% in last year's programme) vs. +0.3%, reflecting reduced gains from the refinancing of maturing debt in particular.

[10] Including employment-related expenditures declining sharply from 2004 and 2006 plus marginal increases in family benefits and moderate increases in housing benefits.

As a percentage of net tax revenue, debt service charges should increase to nearly 16%.



Retirement expenditure

As an increasing number of public sector employees reach retirement age, retirement expenditure will grow more rapidly than in recent years, rising by more than 5% p.a. over 2004-2006, compared with 4% over the last five years.

This growing number of retiring workers will provide an opportunity to adjust recruitment in accordance with restructuring measures undertaken to strengthen the effectiveness of public services.

Other expenditure

Primary expenditures excluding retirement will account for 42% of the central government budget in 2003. Growth in this expenditure category – which includes, on the one hand, payroll, and on the other, operating, intervention, and investment expenditures – will be limited to an average of approximately €1.2 billion p.a. over 2004-2006.

Growth in the payroll must not exceed inflation (+1.5% p.a.) in order to stabilize, in current euros, operating (excluding personnel), intervention, and investment expenditures, including those for the government's priorities.

Changeover from general budget expenditure to national accounts expenditure

The scope of central government expenditure in the national accounting system does not match the scope of general budget expenditure in budgetary accounting, as confirmed by the constitutional bylaw on budget acts of 1 August 2001. Two key factors contribute to the growth in expenditure in national accounting:

- **Certain levies on revenue** *are treated as central government expenditures. These concern, for instance, measures designed to offset the impact of reforms involving the local business tax and the GNP-based resource that contributes to the financing of EU institutions;*

- *Central government expenditure also includes imputed* **social security contributions,** i.e. *contributions that the central government would have to pay to balance civil service and military pension schemes if it did not pay the benefits itself. Given the increase in the number of retirements, this expenditure is likely to rise significantly over the programme period. The impact of this correction on the central government balance is neutral;*

- *Other adjustments also increase growth in general budget spending with regard to national accounts, such as changeover to accrual-basis accounting, debt cancellation for developing countries, expenditure in special Treasury accounts, and specific budgets.*

Table 6: Central government budget accounting and national accounts expenditure
(Contribution to growth in expenditure under the national accounting system: 2004-2006)

(At constant prices, %)	2004-2006
General budget expenditure (like-for-like basis)	**1.0**
Levies on revenue in budget accounting	**1.0**
For local government *(including compensation for the business tax reform)*	*0.2*
For the European Union (GNP-based resource)	*0.8*
Imputed social security contributions	0.5
Other adjustments	-0.1
Central government expenditure in national accounting	**2.4**

The financing of France's contribution to the European community budget

During the programme period, France's participation in the European Community budget will progressively be financed by a GNP-based resource at the expense of intra-community VAT transfers. However, GNP-based financing, founded on national wealth, is recorded as an expense in the European system of accounts (SEC95). This accounting method naturally increases central government expenditure and, by extension, that of the general government. Because this impact will be more significant in 2004 than in 2005 and 2006, the shift to the GNP-based resource partially explains the sharper increase in public expenditure at the beginning of the programme period.

Social security funds expenditure

Social security expenditure will increase, on a like-for-like basis, by 1.6% p.a. at constant prices, on average, until 2006, slightly more than projected in the previous programme. Such performance will require the pursuit of the efforts to contain spending launched in 2003.

For **healthcare expenditure** falling under the scope of the national health insurance spending target[11], cumulative growth of 2.5% p.a. in real terms over the 2004-2006 period is maintained. After strong growth in 2000 (+4.0% at constant prices), in 2001 (+4.0% at constant prices), and in 2002 (5.5% at constant prices, according to the *Commission des Comptes de la Sécurité Sociale* of September 2002), such a reversal implies the pursuit of healthcare system reforms initiated in 2003. In implementing these reforms, considerable attention will be devoted to maintaining the high quality of France's healthcare system.

[11] ONDAM (*Objectif national des dépenses d'assurance maladie*)

The first step in this reform will be to rationalize prescription drug expenditure, which represents the most significant share of health spending in France. To this end, the 2003 Social Security Financing Bill proposes an initial set of measures: application of fixed amounts for prescription drug reimbursements pegged to generic drug prices and progressive elimination of reimbursements for prescription drugs of limited clinical utility. These represent long-term measures, and application will be extended and reinforced between now and 2006.

To assist doctors in the performance of their mission, one provision of the 2003 Social Security Financing Bill shifts the focus from oversight of the activity of medical practitioners to providing recommendations. This additional effort should contribute to rationalizing prescription drug expenditure. At the same time, the cost-control mechanism which imposed an adjustment of doctors' statutory fees in case of exceeding set limits will be eliminated. Pending the new regulation for healthcare networks, the three-year authorization for healthcare sectors and networks was renewed until 31 December 2004.

In addition, a reform of the hospital sector *("Hôpital 2007")* will generate savings through the introduction of pricing by activity combined with incentives and tools to improve management. The 2003 Social Security Financing Bill provides for significant hospital investment, financed, in part, by the 'modernization' fund for healthcare establishments. Pilot projects of the activity-based pricing system will be launched starting in 2003 and are scheduled for general application in 2004. In line with this goal of improving hospital management, a major audit will be launched to assist hospitals and to implement indicators to improve their performances.

The 2003 Social Security Financing Bill provides for major consultation with parliament to define the government's objectives in the area of healthcare reform. To this purpose, a parliamentary assessment office was created to oversee the application of healthcare policy, gather information, and implement studies, and to oversee, monitor, and evaluate these policies.

The 2003 Social Security Financing Bill is thus the first phase of an ambitious, coherent reform of the French healthcare system aimed at ensuring its long-term viability and the quality of services provided.

Future initiatives of the government involve the launching of several working groups that will include members of parliament, business and labour groups, and social security funds, in order to:

- Clarify the respective roles of central government and the social security funds;
- Set health insurance spending targets based on medical criteria;
- Allocate coverage between basic insurance and complementary insurance schemes.

Old-age benefits will increase at a rate of **7.1%** (at constant prices) over the 2004-2006 period. This figure is the result of a relatively low rate in the early part of this period, comparable to 2001 and 2002, reflecting the impact of the relatively small number of people who were born during WWII and who are now reaching retirement age. This will be followed by an influx of baby-boom generation retirees in greater numbers.

The government has announced its intention to reform retirement systems in order to guarantee their future:

- The reform must succeed in establishing a more equitable allocation among beneficiaries while taking into account the diversity in the situation and status of various categories of workers, in particular where demographic issues are concerned;
- Freedom of choice will be introduced, allowing persons who so wish to work longer in order to increase their benefits;
- All workers will be entitled to supplement their pension benefits through retirement savings schemes;
- The efforts required will be shared equitably.

The government has indicated that the measures must be defined after broad-based consultations with business and labour groups between now and the end of the first half of 2003.

Family benefits will rise marginally, particularly in the early part of the period as the number of persons qualifying for benefits for preschool children increases.

Finally, **unemployment insurance** benefits should decline by 3.2% p.a. on average, at constant prices, over the period. In the short term, corrective financial measures may be implemented if necessary. Over time, the improvement in the job market, combined with the impact of the new unemployment insurance agreement signed in 2000, should facilitate a more rapid return to employment by job seekers. In this way, unemployment benefits should contribute to limiting expenditure on social benefits.

A pension reserve fund (FRR) was created by the Social Security Financing Bill of 1999. This reserve fund aims at easing the impact of the demographic crisis on retirement schemes by building up reserves between now and 2020. This reserve is funded from social contributions (2%), old-age insurance fund surpluses (*Caisse nationale d'assurance vieillesse* and *Fonds de solidarité vieillesse*) and income from its assets.

Local government expenditure

Local government expenditure should grow at slightly under 2% per year at constant prices over the programme period. This increase will be more rapid than for total general government expenditure (1.3% at constant market prices, on average). However, local spending growth will be slower than in 2002-2003 (2.5% p.a. at constant prices), a period that was affected by the introduction of the long-term care allowance for the elderly (APA) and the implementation of the reduced 35-hour working week. The application of the APA[12] should be largely completed by the end of 2003, and, in consequence, will no longer fuel local spending increases between 2004 and 2006. Similarly, the hiring of additional personnel made necessary by the reduction of the legal working week should be completed between now and the end of 2003.

Investment by local government will remain sustained over the programme period. In nominal terms, investment will increase by an average of 4.8% p.a. until the end of the programme period, reflecting an investment cycle between two local election periods. Structural factors will provide further impetus to local spending: investment in treatment facilities for water and household waste and contracts between the State and the regions (*contrats de plan*). Debt service charges will decrease as local government continues to reduce its debt. As a result, local government will achieve a balanced budget for the period.

Expenditure by central government bodies

Expenditure by central government bodies will be modest as accrued interest expenses on the social security debt decline and the defeasance structures are progressively phased out.

[12] **A working group of central and local government will be implemented to evaluate the system**. Its objective will be to reconcile, in a more effective manner than today, both the obligation of assuring national solidarity and responsible local management, indispensable to ensuring the long-term viability of the system.

IV. Taxes and social security contributions

Tax and social security contribution cuts were implemented for 2002 and 2003 in order to stimulate job creation and the growth of the French economy. In particular, these cuts were in the form of targeted social security relief in favour of young jobseekers and low-skilled workers, a reduction in income tax bracket rates, and the continued reform of the local business tax.

Further tax and social security cuts will be made between 2004 and 2006 in addition to those already adopted in 2002 and those slated for the 2003 Budget Bill. These measures represent relief of approximately €15 billion in tax and social security contributions over 2002-2006[13], in the 2.5% growth scenario. In the second scenario of 3% medium-term growth, cuts of an additional € 4 billion are foreseen, representing a total of €19 billion over 2002-2006.

Under this programme, reforms to implement further reductions in social security contributions between 2004 and 2006 are provided for in the "Wages, working hours and job stimulation measures" bill. Measures to reduce social security contributions are broadened and better targeted in favour of lower salaries. Because these measures focus on salaries in the lowest wage range, exemptions will provide a more effective stimulus to job creation while avoiding the dilutive effect of previous measures. In conjunction with the loosening of regulations on working hours, these measures should reduce structural unemployment and strengthen France's medium-term growth potential.

To cover potential needs arising from possible increases in unemployment insurance expenditure and hikes in local taxes, a reserve of €3 billion over the 2004-2006 period was budgeted in this programme.

The process of decentralization may modify the allocation of tax revenue among general government entities over the medium term. At this stage, the outline of the reform has not been completely established, particularly where eventual transfers of resources and authorities are concerned. On this point, the multiyear programme is based on forecast trends for public finances.

The total tax burden will be reduced to 44.1 GDP points in 2006. However, because of the automatic increase in the tax burden linked to an improved economy, particularly in 2004, and the accounting method employed for recording social security contribution relief for charge-free jobs for young people, this decline does not fully reflect the cuts provided for in the programme period.

[13] By including "*contrats jeunes en entreprise*" (charge-free jobs for young people), which are recorded as public spending increases in the national accounts rather than as reductions in tax and social security contributions.

V. General government debt

Table 8: Gross debt ratio of general government

In GDP points	2001	2002	2003	2004	2005	2006
2.5% growth scenario						
Gross debt ratio	57.3	58.7	59.1	58.9	58.3	57.0
3% growth scenario						
Gross debt ratio	57.3	58.7	59.1	58.5	57.3	55.4

Note: Excluding the impact of the recapitalization of France Telecom and the sale of the central government's stake in Crédit Lyonnais.

In 2002, in response to weakening economic growth combined with a deterioration in the public accounts, the debt ratio should increase by more than one point. The weight of debt in GDP will decrease starting in 2004. Reducing public debt as a percentage of GDP is critical in the face of ageing population trends in order to provide for long-term resources to attenuate the impact of this demographic crisis on public finances.

In the 2.5% growth scenario from 2003 to 2006, the debt ratio will fall by 2 GDP points, from 59.1 GDP points to 57.0 GDP points. The actual primary surplus will increase sharply over 2004-2006, whereas the stabilizing balance will remain steady at 0.8 GDP points, contributing to a progressive decline in the debt ratio. The apparent cost of debt, which represents the average nominal interest rate for borrowed sums outstanding, will in turn decline[14]. Expressed as a nominal value, public debt will represent approximately € 1000 billion in 2006. In the 3% growth scenario, debt as a percentage of GDP will decline further to 55.4 GDP points in 2006.

Table 9: General government debt ratio ***(2.5% growth scenario)***

In GDP points	2001	2002	2003	2004	2005	2006
Debt ratio	57.3	58.7	59.1	58.9	58.3	57.0
Change in the debt ratio	0.0	1.4	0.4	-0.2	-0.6	-1.2
Apparent cost of debt	5.6	5.4	5.4	5.3	5.4	5.5
Nominal GDP growth (%)	3.3	2.9	3.9	4.0	4.0	4.0
Actual primary balance	1.8	0.4	0.6	1.0	1.5	2.1
Stabilizing primary balance (excluding flows of claims)	1.3	1.5	1.0	0.8	0.8	0.8
Interest payments	3.2	3.2	3.2	3.1	3.1	3.1

By sub-sector, the general government debt ratio will decline primarily in response to the reduction of the central government deficit and improved net lending by central government bodies (primarily the Social Security Debt Repayment Fund, the Pension Reserve Fund, and the defeasance fund of Crédit Lyonnais) and by local government[15].

[14] The sensitivity of debt service charges to interest-rate fluctuations is limited because a significant portion of debt is issued at fixed rates with maturities exceeding five years.

[15] It should be noted that Pension Reserve Fund (FRR) acquisition of government bonds previously held by the private sector and local government reduce consolidated public debt. In contrast, changes in the holdings of different sub-sectors regarding one another's debt do not affect consolidated public debt.

Central government investment in France Telecom in order to recapitalize the company, announced on 4 December, will have an impact on general government debt but not on the deficit, according to the terms of the Maastricht Treaty (excluding interest expense on the transaction).

VI. The stability programme and the Budget Act

A review of previous stability programme objectives highlights the progressive relaxing of expense targets and the scope of slippage in 2002. Healthcare represented the largest contributor to cost overruns (5.5% growth at constant prices). Central government expenditure also sharply exceeded initial targets of 0.5% at constant prices. However, this cost overrun of €4.9 billion is primarily the result of non-recurring expenditures of an exceptional nature with respect to the nature and shortfall of allocations for 2002. These expenditures have not been maintained in the 2003 Finance Bill.

Table 10: Public expenditure in 2002
2001-2003 stability programme (January 2000) vs. current projections (November 2002)

Change at constant prices	2002			
	SP 01-03*	SP 02-04*	SGP 03-05	Current projection
General government	**1.3**	**1.6**	**2.2**	**3.6**
Central government (budget accounting)	0.3	0.3	0.5	2.9
Social welfare payments	1.4	1.6	2.3	4.4
- Of which health benefits	*1.5*	*1.8*	*2.3*	*5.5*
Local government	1.9	1.7	2.8	3.2

*On the basis of a straight-line increase in expenditure over each of the periods

In 2003, by contrast, general government expenditure growth will return to a more moderate rate of approximately 1.2% at constant prices.

Expenditure-control targets for central government are significant in 2003, with projected increases of only 0.2% at constant prices. Moreover, in calculating this projection, important exceptional expenditures applied in 2002 were not included. In actual terms, budget spending will decline significantly in 2003.

Spending increases budgeted for in the 2003 Social Security Financing Bill – 2.2% at constant prices – are higher than in previous programmes. This difference reflects efforts to achieve a greater degree of credibility in projections and to make them more realistic:

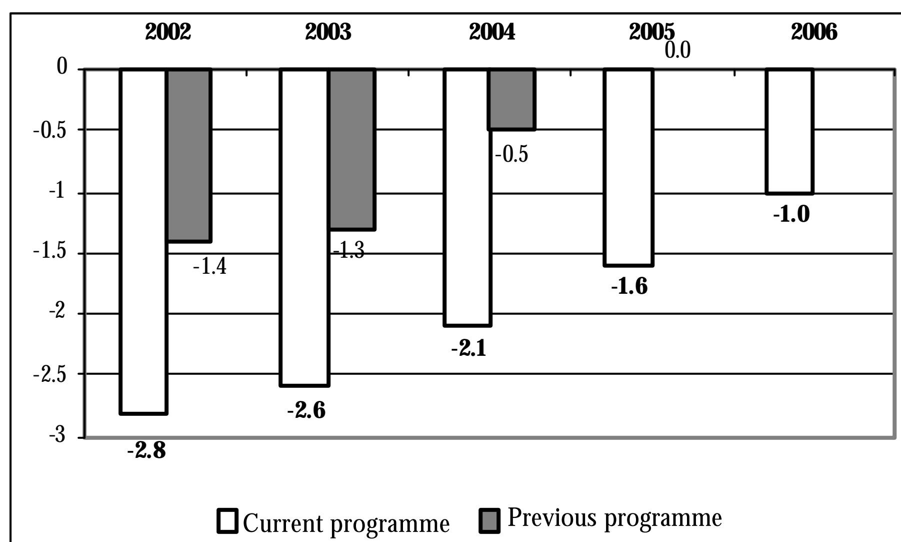
- Make them more realistic, because in recent years, the national health insurance spending target (ONDAM), which was set at an overly ambitious level, was never met. In particular, health insurance expenditure was the principal contributor to the surge in total expenditure in 2002 (5.5% growth at constant prices);
- Credibility, because the new provisions of the 2003 Social Security Financing Bill guarantee compliance with this target: new measures of control (for example, the non-reimbursement for prescription drugs whose effectiveness is unproven[16]) make it possible to anticipate a significant deceleration in the rise of healthcare costs. In addition, corrective measures will be implemented during the year if the targets are exceeded.

[16] For further detail, please see Chapter III.

VII. From one stability programme to the next

The updated programme highlights a sharp drop in general government net borrowing in 2002 (-2.8%, vs. the -1.4% announced in the previous programme). Deficit reduction trends between 2003 and 2006 are, in contrast, comparable from one programme to the next even if the underlying assumptions have changed. In conjunction with the reduction in net borrowing, the 2004-2006 programme provides for tax and social security contribution cuts to stimulate economic growth.

Comparison of public deficit trends in the current and previous programme (2.5% growth scenario)



Forecast reductions in public expenditure as a percentage of GDP in the current programme are comparable to last year's programme (which projected a decline of 1.8 GDP points in three years), despite a faster increase in the debt service charge and the shock precipitated by an ageing population.

Central government debt service charges will increase by more than € 6 billion over 2004-2006, compared with only €0.7 billion over 2000-2002.

Central government retirement expenditure will rise by more than €5 billion over 2004-2006, compared with €3 billion over 2000-2002. Social security retirement expenditure (particularly under the general insurance scheme) will rise by 7.1% over 2004-2006, compared with the 5.8% forecast for 2003-2005 in last year's programme.

Table 11: Cumulative growth of real expenditure from 2004 to 2006

Change at constant prices	2003-2005 programme	2004-2006 programme
General government	**4.0%**	**3.9%**
Central government (budget accounting)	1.0%	1.0%
Central government (national accounts)	2.2%	2.4%
Social security funds	4.5%	5.0%
- Health benefits	*5.5%*	*7.7%*
- Retirement pensions	*5.8%*	*7.1%*
Local government	6.6%	5.8%
GDP (2.5% growth scenario p.a.)	**7.7%**	**7.7%**

Growth in local government expenditure should be slightly less dynamic over 2004-2006 than forecast for 2003-2005. This change reflects, in particular, the completed implementation of the new long-term care allowance and the achievement of the changeover to the shorter working week which had fuelled payroll increases. These projections do not take into account the impact of transfers of authority within the framework of decentralization measures, which will affect local government revenue and expenditure.

Health insurance expenditure will increase more sharply than in the previous programme. This difference mainly reflects efforts to increase the credibility of the projections and to make them more realistic. Health insurance expenditure increases will keep pace with GDP over 2004-2006. This credibility will be guaranteed by the definition of new mechanisms to regulate healthcare supply and demand, especially in the system of ambulatory care providers.

Retirement benefit expenditure will also be significantly higher than in the preceding programme as the baby boom generation reaches retirement age in large numbers, especially at the end of the programme period. This difference is the result of the progressive increase in retirement benefit expenditure in the coming years.

Declining slightly at constant prices, other social security expenditures will advance at a more modest pace than forecast over the 2003-2005 period: the implementation of the 35-hour working week in hospitals will be completed in 2003; unemployment benefits will decline sharply at constant prices; and housing and family benefits will be strictly contained. As a result, total growth in social spending should not exceed 5% over three years, or 0.5% more than in the previous programme.

VIII. Long-term public finance guidelines

A strategy for public finances that anticipates the effects of the demographic crisis

Population ageing poses a major challenge to our public finances, undermining long-term viability if corrective measures are not taken. Without reform, expenses related to demographic trends (retirement, health, and the care of dependent persons) will surge sharply over the coming years.

In the area of retirement pension expenditure, the lasting decline in the percentage of active workers in the total population will have a permanent impact on financing benefits. In 2040, the ratio of retired to active workers will be 7 to 10 compared with only 4 to 10 today. Growth in pension benefits will significantly outpace contributions, threatening the financial solvency of long-term retirement systems. Regarding health and the care of dependent persons, the growing percentage of senior citizens in the total population will provide the impetus for significant spending increases. Overall, recent simulations based on the existing system for financing health and welfare benefits forecast an increase of approximately 6 GDP points from 2005 to 2040 for primary expenses geared towards retirement, health, and the care of dependent persons. An increase of this magnitude would threaten the long-term viability of our public finances.

Table 12: Forecast growth of primary expenses for old-age benefits
in GDP points

	2000	2040	Variation
Health and long-term care	6.9	8.9-9.4	1.7-2.5
Retirement	12.1	15.8	3.7

Source: The Ageing Working Group, Economic Policy Committee, European Commission

However, the system's long-term viability will depend on our ability to assure permanent and sustainable financing for costs linked to population ageing so that the debt ratio remains stable or

virtually stable starting in 2040. Two mechanisms of reform must be pursued simultaneously to assure the system's long-term viability without being forced to implement sharp, rapid increases in the tax burden:

- First, a reform of the retirement system, modifying the parameters and structure of pension funds, could significantly reduce the impact of population ageing. The effects of this reform would be achieved over the long term;
- Second, measures to rapidly reduce debt by maintaining general government net borrowing above levels that would stabilize debt as a percentage of GDP, producing results within the next 15 years. This strategy would significantly reduce the share of public revenue devoted to debt service charges (today 3 GDP points) and allow for a reallocation towards financing other needs.

Government priorities highlighted in the stability programme

The 2004-2006 stability programme provides for a reform of retirement systems combined with ongoing debt-reduction measures. In this way, a retirement system reform will be defined before the end of the first half of 2003 – in line with the timetable announced by the Prime Minister – based on several principles: while guaranteeing the viability of the pay-as-you-go system, it will establish a more equitable allocation among beneficiaries while taking into account the diversity in the situation and status of various categories of worker, particularly regarding demographic factors. Freedom of choice will also be introduced, allowing persons who so wish to work longer and increase their entitlement to pension benefits.

All workers will be entitled to supplement pension benefits through retirement savings schemes. The efforts required will be shared equitably.

In conjunction with this reform, recourse to early retirement will be phased out in an effort to increase the percentage of older workers in the workforce.

The 2004-2006 stability programme also reflects the French government's determination to rapidly bring down debt in order to quickly benefit from the dual dividends provided by lower debt service charges. In this way, ongoing improvements in the primary balance over the period will reduce the weight of debt in GDP from 59.1% in 2003 to 57.0% in 2006 (in the 2.5% growth scenario).

IX. Key figures

IX.1. 2.5% growth scenario

General government balance

(in GDP points)

	2002	2003	2004	2005	2006
Net lending(+) / Net borrowing (-) (B9)					
General government	**-2.8**	**-2.6**	**-2.1**	**-1.6**	**-1.0**
Central government: State	*-3.4*	*-3.0*	*-2.8*	*-2.5*	*-1.9*
Other central government bodies	*0.6*	*0.5*	*0.5*	*0.6*	*0.7*
Local government	0.2	0.1	0.2	0.3	0.3
Social security funds	-0.2	-0.2	0.0	0.0	0.0
General government (S13)					
Total revenue	51.2	50.8	50.7	50.6	50.5
Total expenditure	54.0	53.4	52.8	52.2	51.5
Budget balance	-2.8	-2.6	-2.1	-1.6	-1.0
Net interest payments	3.2	3.2	3.1	3.1	3.1
Primary balance	0.4	0.6	1.0	1.5	2.1

General government gross debt

	2002	2003	2004	2005	2006
Gross debt level	58.7	59.1	58.9	58.3	57.0
Annual change in gross debt	1.4	0.4	-0.2	-0.6	-1.3
Contributions to annual change in gross debt					
Primary balance	-0.4	-0.6	-1.0	-1.5	-2.1
Interest payments	3.2	3.2	3.1	3.1	3.1
GDP growth	-1.6	-2.3	-2.3	-2.3	-2.3

Comparison with the previous programme

2.5% growth scenario

	2002	2003	2004	2005	2006
GDP growth					
Previous programme	2.5	2.5	2.5	2.5	-
Latest programme	1.2	2.5	2.5	2.5	2.5
Difference	-1.3	0.0	0.0	0.0	-
Budget balance					
Previous programme*	-1.4	-1.3	-0.5	-0.0	-
Latest programme	-2.8	-2.6	-2.1	-1.6	-1.0
Difference	-1.4	-1.3	-1.6	-1.6	-
Gross debt level (consolidated general government)					
Previous programme*	56.3	55.7	54.5	52.9	-
Latest programme	58.7	59.1	58.9	58.3	57.0
Difference	2.4	3.4	4.4	5.4	-

* Excluding revenue from UMTS licenses

Macroeconomic assumptions (2.5% growth scenario)

Growth and associated factors

	2002*	2003*	2004	2005	2006
GDP growth at constant market prices	1.2	2.5	2.5	2.5	2.5
GDP growth at current market prices	2.9	3.9	4.0	4.0	4.0
GDP at current market prices (€bn)	1507	1566	1628	1693	1761
GDP deflator	1.7	1.4	1.5	1.5	1.5
Inflation (IPC change)	1.8	1.6	1.5	1.5	1.5
Market sector employment growth	0.7	1.1	1.1	1.1	1.1
Sources of growth: percentage changes at constant prices					
Private consumption expenditure	1.8	2.4	2.6	2.6	2.6
Public consumption expenditure	3.6	1.6	1.1	1.1	1.1
Gross fixed capital formation	0.4	2.1	3.5	3.5	3.5
Changes in inventories**	-0.5	0.8	0.0	0.0	0.0
Exports of goods and services	0.7	6.0	5.5	5.5	5.5
Imports of goods and services	1.5	8.1	5.5	5.5	5.5
Contribution to GDP growth					
Final domestic demand	1.4	3.0	2.6	2.6	2.6
Changes in inventories and net acquisition of valuables as a % of GDP	-0.5	0.8	0.0	0.0	0.0
External balance of goods and services	-0.2	-0.4	0.0	0.0	0.0

**Assumptions of the 2003 Budget Bill*
***As a contribution to GDP*

IX.2. Scenario of 3% growth

General government balance

(in GDP points)

	2002	2003	2004	2005	2006
Net lending (+) / Net borrowing (-) (B9)					
General government	-2.8	-2.6	-2.0	-1.4	-0.5
Central government: State	-3.4	-3.0	-2.8	-2.5	-1.9
Central government bodies	0.6	0.5	0.5	0.6	0.7
Local government	0.2	0.1	0.3	0.3	0.4
Social security funds	-0.2	-0.2	0.1	0.2	0.4
General government (S13)					
Total revenue	51.2	50.8	50.6	50.3	50.3
Total expenditure	54.0	53.4	52.6	51.7	50.8
Budget balance	-2.8	-2.6	-2.0	-1.4	-0.5
Net interest payments	3.2	3.2	3.1	3.1	3.1
Primary balance	0.4	0.6	1.1	1.7	2.6

General government gross debt

	2002	2003	2004	2005	2006
Gross debt level	58.7	59.1	58.5	57.3	55.4
Annual change in gross debt	1.4	0.4	-0.6	-1.1	-1.9
Contributions to annual change in gross debt					
Primary balance	-0.4	-0.6	-1.1	-1.7	-2.6
Interest payments	3.2	3.2	3.1	3.1	3.1
GDP growth	-1.6	-2.3	-2.6	-2.5	-2.5

Comparison with the previous programme

3% growth

	2002	2003	2004	2005	2006
GDP growth					
Previous programme	2.5	3.0	3.0	3.0	
Latest programme	1.2	2.5	3.0	3.0	3.0
Difference	-1.3	-0.5	0.0	0.0	-
Budget balance					
Previous programme*	-1.4	-1.0	0.0	0.3	-
Latest programme	-2.8	-2.6	-2.0	-1.4	-0.5
Difference	-1.4	-1.6	-2.0	-1.7	-
Gross debt level (consolidated general government)					
Previous programme*	56.3	55.3	53.6	51.8	-
Latest programme	58.7	59.1	58.5	57.3	55.4
Difference	2.4	3.8	4.9	5.5	-

* Excluding revenue from UMTS licenses

Macroeconomic assumptions (3% growth scenario)

Growth and associated factors

	2002*	2003*	2004	2005	2006
GDP growth at constant market prices	1.2	2.5	3.0	3.0	3.0
GDP growth at current market prices	2.9	3.9	4.5	4.5	4.5
GDP at current market prices (€bn)	1507	1566	1636	1710	1787
GDP deflator	1.7	1.4	1.5	1.5	1.5
Inflation (IPC change)	1.8	1.6	1.5	1.5	1.5
Market sector employment growth	0.7	1.1	1.6	1.6	1.6
Sources of growth: percentage changes at constant prices					
Private consumption expenditure	1.8	2.4	3.1	3.1	3.1
Public consumption expenditure	3.6	1.6	1.1	1.1	1.1
Gross fixed capital formation	0.4	2.1	4.7	4.7	4.7
Changes in inventories**	-0.5	0.8	0.0	0.0	0.0
Exports of goods and services	0.7	6.0	6.1	6.1	6.1
Imports of goods and services	1.5	8.1	6.1	6.1	6.1
Contributions to GDP growth					
Final domestic demand	1.4	3.0	3.1	3.1	3.1
Changes in inventories and net acquisition of valuables as a% of GDP	-0.5	0.8	0.0	0.0	0.0
External balance of goods and services	-0.2	-0.4	0.0	0.0	0.0

**Assumptions of the 2003 Budget Bill*
***As a contribution to GDP*